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ON THE GAINS RECEIVED BY TARGETS AND
BIDDERS FROM MERGER

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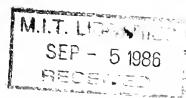
THE IMPORTANCE OF STRATEGIC FIT
ON THE GAINS RECEIVED BY TARGETS AND
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Lois Shelton*

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THE IMPORTANCE OF STRATEGIC FIT ON THE
GAINS RECEIVED BY TARGETS AND BIDDERS FROM MERGER

I. INTRODUCTION

Empirical studies, such as Singh and Montgomery (1984), Lubatkin (1984) and Shelton (1985a and b), have determined that the combined gains received by target and bidder firms from acquisition vary by the strategic characteristics of the merger. These findings quite naturally lead to the following question: Does strategic fit play an equally important role in determining the gains of targets and the gains of bidders?

When target and bidder assets are combined through merger, a certain amount of economic value is created. The target firm's share of this value is the premium above market value paid by the bidder while the bidder receives the remaining value created after the premium is paid to the target.

If strategic fit is a key factor in determining the size of the premium received by targets, then target shareholders should seek out merger partners with specific strategic characteristics. Likewise, if strategic fit is a key determinant of the residual returns received by bidders, they should choose their merger partners accordingly.

This study explores the relative importance of strategic fit for targets and bidders. The following section examines the demand and supply of target firm shares. Testable hypotheses based on this framework are presented in Section III and the construction of the database and key variables are discussed in Section IV. In Sections V and VI, regression models and statistical results are analyzed. Conclusions and implications are presented in Section VII.

II. THE DEMAND AND SUPPLY OF TARGET FIRM SHARES

An examination of the demand and supply conditions for target firm shares provides a theoretical basis for testable hypotheses regarding the relative importance of strategic fit for targets and bidders respectively. The premium received by target firm shareholders is determined by the supply curve for target firm shares. A bidder's demand for a target results from the gain expected from that target. If strategic fit plays a large role in determining bidder demand, then strategic fit will be a key source of bidder firm gains. The same reasoning holds for the supply of target firm shares and target firm gains.

A. Supply Conditions

Individual and aggregate supply curves for a target firm's shares are illustrated in Figure A. Each target firm shareholder has a set of expectations regarding the future cash flows of the firm. These expectations form the reservation price, P' , at which the shareholder is willing to sell his/her holdings.

The diversity of expectations among target shareholders determines the pattern of the points which compose the aggregate supply curve in Figure A. Only two restrictions are imposed on the points which define an aggregate supply curve: i) only one point corresponds to each offer price, and ii) the number of shares tendered is monotonically increasing in the price offered to purchase those shares.

The horizontal distance between points indicates the incremental number of shares offered for each increase in price. When many individual shareholders have identical expectations and therefore, the same reservation price, then a large block of shares will be tendered when this reservation price is reached.

The vertical distance between two points is one measure of how much the expectations of successive groups of shareholders differ. If the reservation price of one group differs greatly from that of another, then the expectations of the two groups must also differ greatly.

Thus, the elasticity of the aggregate supply curve serves as one measure of the level of heterogeneity in target shareholder expectations. As differences in shareholder expectations increase, the vertical distance between points will also increase due to the wider dispersion of reservation prices. However, horizontal distances will shrink as heterogeneity of expectations rises, assuming that the number of shares held by each target shareholder remains constant.

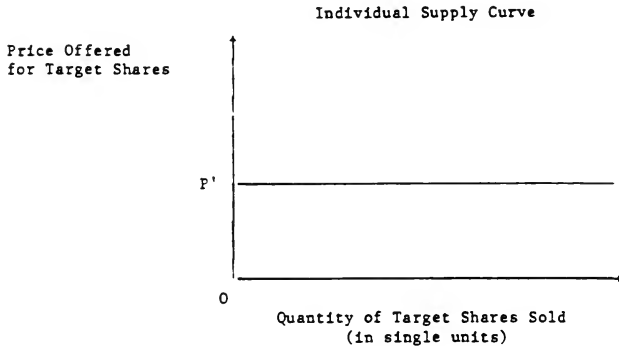
When the aggregate supply curve is perfectly elastic, then all shareholders share identical expectations and the aggregate supply curve is identical to the individual supply curve in Figure A, in which all shares are tendered at a single price P' . The restriction that the number of shares tendered increase monotonically in the purchase price offered prevents a perfectly inelastic aggregate supply curve, in which a certain number of shares will not be sold at any price.

The aggregate supply curve of Figure A illustrates the size of the premium over market value that an acquiring firm must pay to purchase a certain number of target firm shares. In order to buy Q^* shares, the bidder must pay a premium of $(P^* - P)$. This premium, which is paid to gain control, is the gain received by target shareholders.

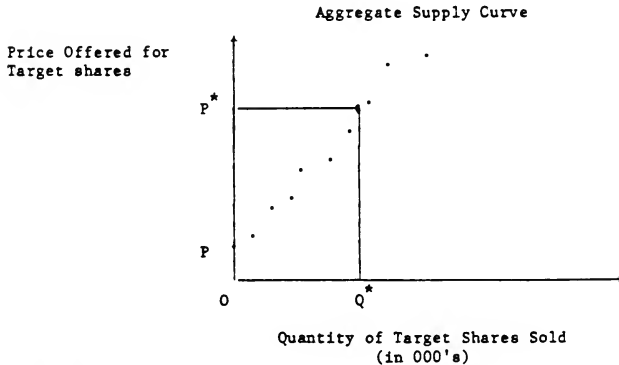
The previous analysis shows that the heterogeneous expectations of target shareholders regarding the future cash flows of the firm are key to determining the size of the premium required to gain control. The strategic fits between target and bidder will have negligible effects

FIGURE A

Aggregate and Individual Supply Curves for Target Firm Shares



- At prices $\geq P'$, the individual sells all of his/her shares
- At prices $< P'$, the individual does not sell any shares



- At any given price exceeding the market price P , groups of individuals with similar expectations about the firm's future performance are willing to sell their shares.
- As the price offered rises, the number of shares tendered rises.

on these expectations since target shareholders evaluate tender offers against the expected cash flows of the target firm alone and against any competing offers. Target firm shareholders do not consider the expected cash flows of both firms together since they will not control the combined firm after acquisition.

B. Demand Conditions

The following analysis of a bidder's demand for target shares consists of two parts: i) the internal selection process used by bidder's management to decide which target firm to pursue during the relevant planning period, and ii) the competition with other bidders, if any, for the desired target.

Bidder firms are assumed to consider one acquisition during a given planning period. Bidders rank potential targets by the gains which they expect to receive and then seek control of these targets sequentially. Figure B illustrates this sequential pursuit process as well as the bidder demand for the shares of a particular target at time.

Bidders rank targets by the present value of expected net benefits from completing the acquisition. The gains received by a successful bidder equal the value created by combining the assets of the two firms minus premium required to obtain control. Targets which are expected to command lower premiums may be ranked higher than targets that would

FIGURE B

Bidder Decision Process for Ranking and Pursuing Targets

Determine Expected Gross Benefits from Acquiring Potential Targets A, B,....Z, where Expected Gross Benefits = Expected Value Created and Expected Increases in Managerial Utility



Determine Premium Required to Gain Majority Control of Potential Targets A, B,....Z,



Rank Potential Targets A, B,....Z, by Expected Net Benefits where Expected Net Benefits = Expected Gross Benefits - Premium Required



Acquire Target A if control can be purchased such that Expected Net Benefits from A exceed Expected Net Benefits from Next Best Alternative B



Acquire Target B if control can be purchased such that Expected Net Benefits from B Exceed Expected Net Benefits from Next Best Alternative C



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. .
. .
. .

FIGURE B
(continued)



Acquire Target Z if Control can be Purchased
such that Expected Net Benefits exceed Return
Expected from Next Best Alternative Use of Funds

*Ranking of Potential Targets A, B, . . . Z from
highest Expected Net Benefits to lowest
corresponds to alphabetical order

create more value, if the former provide larger absolute gains to the bidder. Thus, the reservation purchase price depends on the required premium, the total value created and the gains available from other targets.

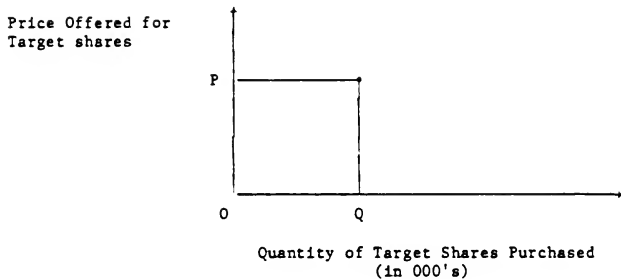
The following example illustrates the relationship between value created, or gross benefits, premium required, and net benefits offered by alternate targets. Suppose that the bidder is considering acquiring one of two targets, X and Y. Target X is expected to provide \$110 in gross benefits and to require a premium of \$90, and so Target X will yield \$20 in net benefits. Target Y is expected to yield \$15 in net benefits since it is expected to create \$100 of value and to require a premium of \$85. The existence of Target Y means that the bidder is willing to pay a maximum of \$95 to acquire X because at that price, the net benefits yielded by both firms are equal. If Target X costs more than \$95, then the bidder will move on to Target Y. This process of successive bidding is illustrated in Figure B.

The bidder's demand for the shares of the chosen target will appear as the single point in the graph of Figure C. The success of this offer depends upon how many target shares are tendered, which is indicated by the aggregate supply curve of the target.

Once an offer is made, the bidding firm may face competition from other suitors. A bidding firm will top the offer made by a competitor if the reduced net benefits that it can expect to receive from a higher

FIGURE C

Bidder Demand for Shares of a Target



Bidder is assumed to contemplate acquiring a single target during the planning horizon.

offer still exceed the expected net benefits from other potential targets. Thus, the bidder which expects to create the most economic value with the assets of the target is most likely to win the competition for the target firm.

Strategic fit should be an important determinant of the gains received by the bidding firm since the economic value expected from combining bidder and target assets is a key consideration for the bidder throughout the bidding process.

III. HYPOTHESES

The following two hypotheses result from analyzing the demand and supply of target firm shares:

H1: Strategic fit will explain some of the variance in bidder shareholder gains.

If this hypothesis is true, then the coefficients on one or more of the strategic fit variables will be statistically significant in a regression equation explaining the gains from merger received by bidder shareholders.

H2: Strategic fit will not explain the returns to target firm shareholders. Variables unrelated to strategy will explain some of the variance in target shareholder gains.

If this hypothesis is true, then the coefficients on strategic fit variables in a regression equation explaining the gains to merger for targets should be statistically insignificant, but the coefficients of other variables related to premium size should be significant.

IV. DATA AND CUMULATIVE RESIDUALS METHODOLOGY

The acquisitions in this study were obtained by randomly selecting bidding firms according to the methodology of Rumelt (1974, 1978). The initial universe of bidders was the 238 firms in Rumelt's 1978 database. Rumelt collected this sample by randomly selecting 100 Fortune 500 industrial companies in 1949, 1959 and 1969 and 50 of these companies in 1974. If a firm was selected in more than one random sample, it appeared only once in the database. An additional random sample was taken of 100 Fortune 500 industrial companies in 1979 to include more mergers that occurred in the late 1970s and early 1980s.

These randomly selected firms made 114 acquisitions during 1962-1983 that possessed the following characteristics:

- (i) both target and bidder appear on the CRSP tapes;
- (ii) sufficient line of business data is available for both target and bidder to determine the following information for each business unit: percentage of corporate revenue contributed, the products sold, and customers served.

The necessary line of business data were obtained through annual reports, prospectuses and Moody's Industrial Manual.

Strategic fits between target and bidder businesses were measured by pairwise comparisons of line of business data for each business unit of the target and bidder firm. The relationship between each pair of business units was classified into one of four possible strategic categories: i) identical, ii) related-complementary, iii) related-supplementary and iv) unrelated.

If the target unit and the bidder units are in the same business, the strategic fit is classified as identical. In a related-complementary fit, the target unit enables the bidder to integrate forward or backward, to expand the product line or to otherwise consolidate the bidder's market position. By contrast, a related-supplementary target unit permits the bidder to enter new but related markets. The unrelated category is self-explanatory. A more detailed explanation of these strategic fit categories appears in Shelton (1985a and b).

The abnormal returns to the stockholders involved in a merger were estimated using the market model employed by Dodd (1980):

$$R_{jt} = \alpha_j + \beta_j \times R_{mt} + \epsilon_{jt} \quad (1)$$

where: R_{jt} = rate of return on stock j over period t, t=1 day;
 R_{mt} = rate of return on value weighted market portfolio over period t;

$$\alpha_j = E(R_{jt}) - \beta_j \times E(R_{mt});$$

$$\epsilon_{jt} = \text{disturbance term of security } j \text{ in period } t, E(\epsilon_{jt})=0;$$

$$\beta_j = \text{cov}(R_{jt}, R_{mt}) / \text{var}(R_{mt}).$$

For each merger, α_j and β_j were derived by estimating α_j and β_j for both the acquiring and acquired firms for a period of 250 trading days ending approximately three months before the merger press date.

A prediction error for each firm j , PE_{jt} , was calculated for each day around the date of the first public announcement of the merger using the equation $PE_{jt} = R_{jt} - \beta_j \times R_{mt}$. Over 96% of α_j 's estimated were statistically insignificant. The period during which α_j and β_j are calculated is excluded.

Estimates of the value created by a given merger were obtained by summing the PE_{jt} (abnormal change in the rate of return for stock j on day t) for the acquiring firm over a three day period around each merger announcement date to obtain a cumulative prediction error. The change in the market value of the equity of the firm due to merger was determined by multiplying total market equity value by the sum of the PE_{jt} (Δ equity value/equity value).

This process was repeated for target firms in order to obtain the expressions below:

$$\text{target alone} \quad \frac{PE_{\text{target}} \times \text{target equity value}}{\text{target equity value}} = PE_{\text{target}}$$

$$\text{bidder alone} \quad \frac{PE_{\text{bidder}} \times \text{bidder equity value}}{\text{bidder equity value}} = PE_{\text{bidder}}$$

The date of first public announcement is identical to the press date of Asquith (1983) and is considered to be the first day that a merger rumor, discussion, tender offer, proposal, agreement or understanding appears in the Wall Street Journal (WSJ).

In cases where the WSJ reports tender offers, merger discussions or rumors previous to a merger plan or agreement, the announcement day is considered the day upon which first public mention of any merger-related information appears in the Wall Street Journal. If a target firm is pursued by more than one suitor, its stock price begins to rise at the announcement of the interest of the first bidding firm. Thus, for 31% of the mergers, the announcement date for the target firm is earlier than that for the bidder. The bidder's announcement date is the date upon which it first shows any interest in the target.

V. REGRESSION MODELS

The hypotheses discussed in Section III can be tested using regression models. These basic models permit the researcher to control for the effects of merger regulation, subsequent divestiture and other factors while examining the effects of strategic business fit.

Basic Models

$$1) \quad \text{BTVL} = \alpha + \beta_1 \text{RS} + \beta_2 \text{RCP} + \beta_3 \text{I} + \beta_4 \text{TIME} \\ + \beta_5 \text{RIV} + \beta_6 \text{EQF} + \beta_7 \text{PER} + \beta_8 \text{DIVEST}$$

$$2) \quad \text{TTVL} = \alpha + \beta_1 \text{RS} + \beta_2 \text{RCP} + \beta_3 \text{I} + \beta_4 \text{TIME} \\ + \beta_5 \text{RIV} + \beta_6 \text{EQF} + \beta_7 \text{PER} + \beta_8 \text{DIVEST}$$

where:

- BTVL = % change in market value of bidder equity caused by the merger;
- TTVL = % change in market value of target equity caused by the merger;
- RS = percentage of related-supplementary strategic fits, entering related markets;
- RCP = percentage of related-complementary strategic fits, consolidating market position;
- I = percentage of identical strategic fits, remaining in the same market;
- TIME = dummy variable equal to one if the merger occurred after October 1969;
- RIV = dummy variable equal to one if other firms were also bidding for the target;
- EQF = dummy variable equal to one if common stock was used to finance the merger;
- PER = price earnings ratio of the target firm divided by the price earnings ratio of the bidder;
- DIVEST = dummy variable equal to one if the target firm, or a large portion thereof, was subsequently divested.

Strategic fit is measured by the RS, RCP and I variables. In mergers with a high proportion of related-supplementary fits, the target permits the bidder access to new customers and markets. Thus, the bidder will be utilizing the assets of the target in new ways. In identical and unrelated mergers, the bidder is buying the assets of the target to utilize them as the target did. A related-complementary target provides the bidder with new products to sell to its markets. In this case, the target is providing the key assets and skills that create value.

Thus, if strategic fit is important to bidders then the related-supplementary variable should be positive and significant for the bidder equations. If Hypotheses Two is wrong and strategic fit is important for target firms, then related-complementary variables should be positive and significant for the target equations.

Asquith, Bruner and Mullins (1983) found that the time period was statistically significant in explaining merger gains to the bidding firm. When Congress passed the Williams Act in July 1968, this government regulation reduced the freedom that acquiring firms enjoyed in executing merger offers. Schipper and Thompson (1983) find that the Williams Act and other regulations passed from July 1968 until October 1969 reduced the gains to bidding firms.

By requiring bidders to file statements about their plans for the target firm and allowing target shareholders a fixed period in which to withdraw tendered securities, the Williams amendments provided target shareholders with the opportunities to carefully evaluate merger bids. To control for these changes, the sample of acquisitions is divided into two time periods--pre- and post-October 1969. The TIME dummy will equal 1 for acquisitions made during the second period, and should be negative for bidder equations and positive for target equations.

The RIV variable indicates the presence of rival firms involved in bidding for the target firm. The presence of multiple bidders should increase the gain to target shareholders via an auction effect.

Multiple bidders could have either a positive or negative impact on the returns to bidder shareholders. If a competitive bidding situation leads to the winning firm overpaying, then the existence of rivals decreases the return to bidder shareholders.

However, if competitive bidding indicates that the target firm has exceptionally good prospects for creating value, i.e. either high quality assets or very scarce assets, then the RIV variable could serve as a proxy for value-creation potential not measured by strategic fit.

The EQF variable is designed to capture the effects of financing on the value created by a merger. If the bidder firm issues or exchanges equity to finance the merger, uncertainty about the success of the bid may exist that would not be present in a strictly cash

offer. This additional uncertainty could increase the reservation price of risk-averse target shareholders. Therefore, a small negative coefficient is expected on bidder firm equations.

If a merger is motivated by earnings manipulation techniques, then the strategic fit variables will not explain significant changes in value creation. The PER variable should be significant and negative for both bidder and target equations in explaining the changes in value caused by these mergers.

If an acquisition is retained by the acquiring firm until the end of the sample period (1983), then the bidder is assumed to have gained sufficient value or utility from the merger so that keeping the target served the bidder's purposes better than selling it. However, divestiture of the acquisition indicates that the strategic fits did not lend themselves to value creation, the implementation was faulty or both. The divestiture dummy provides an ex-post test of the initial market valuation of the acquisition.

This ex-post test is not perfect since it is less stringent for acquisitions which occur later in the sample period. In addition, other factors influence divestiture such as changes in the competitive environment and organizational learning by the bidder firm.

Despite the limits of the test, one would expect less successful acquisitions to be divested and more successful acquisitions to be retained. The DVEST dummy should have a negative coefficient in both

target and bidder equations. Poor acquisition candidates should command a lower premium and result in less value for the target firm shareholders.

VI. STATISTICAL RESULTS

Analysis of the means of the two dependent variables tested reveals that targets receive a 10.7% gain in equity value, on average, during the three day period surrounding the merger press date while bidders lose 1.4% of their equity value.

In Jensen and Ruback (1983) the average two day announcement effects for successful bidders reported in three separate studies ranged from -1.09% to .07%. The two day effect for bidders in this study is -.8%, which is in the center of the range.

The two day announcement effects for target firms range from a high of 13.4% to a low 6.24%. The two day effect for targets in this sample is 10.%, which is again comfortably in the middle of the range.

A. Gains to the Bidder

The significance of entering related markets (related-supplementary strategic fits) in determining the gains to the bidder in Table 1 shows that strategic fit is an important determinant of the gains received by bidding firms. The positive significant coefficient

TABLE 1

Estimated Coefficients from Regression of Announcement Period
Returns for Bidders on Weighted Strategic Fits between Target and
Bidder Businesses in 114 Acquisitions during 1962 to 1983
(t - statistics in parentheses)

Dependent Variable = % Change in Bidder Equity
measured over the following days:

	<u>t=-1,0</u>	<u>t=-1,1</u>
Independent Variables		
Constant (1)	-.0017 (-.107)	-.02 (-1.24)
ENTERING RELATED MARKETS	.0545 (2.82)	.072 (3.628)
CONSOLIDATING MARKET POSITION	.0089 (.536)	.0089 (.5214)
IDENTICAL MARKETS	.0259 (1.21)	.032 (1.46)
Divested	.002 (.191)	.0006 (.0553)
Equity Financed	-.0068 (-.457)	-.0012 (-.0802)
Rival Bidders	.0173 (2.057)	.02197 (2.54)
Target P-E Ratio/Bidder P-E Ratio	.0005 (.5667)	.00098 (1.04)
Post-Williams Act	-.25 (-3.38)	-.0186 (-2.45)
Adjusted R ²	.128	.149
Mean of Depen- dent Variable	-.0083	-.014

t = 0 is day of first public announcement of merger

(1) Constant incorporates the effect of Unrelated Business Units.

on the Rival Bidders dummy suggests this variable is measuring other aspects of goodness of fit, or value creation potential, that are not picked up by the strategic fit categories. One of these aspects could be high quality assets or strong industry position. Either of these qualities would enhance the value created by a target and would presumably cause it to attract multiple bidders.

A comparison of the earnings per share achieved by targets with and without multiple bidders supports this assumption. In a sample of 242 acquisitions made by randomly selected bidders during 1962 to 1983, targets with two or more rival bidders earned an average of \$2.71 per share. Their less sought after counterparts earned only \$1.51 per share on average.

The Time, or Post-Williams Act, dummy, which is 1 for all mergers occurring after the passage of the Williams Act in October 1969, is negative, as expected, since this legislation reduced the freedom of bidder firms in making merger bids.

B. Gains to the Target

The regression results for target shareholder gains are displayed in Table 2. The key variable for explaining the gains to target firms is the Post-Williams Act dummy, which is positive as expected. The passage of the Williams Amendments provided target shareholders with a fixed period of time to evaluate tender offers or merger bids and thus, lowered the probability that target shareholders would be pressured into accepting a very low offer.

TABLE 2

Estimated Coefficients from Regression of Announcement Period
Returns for Targets on Weighted Strategic Fits between Target and
Bidder Business units in 114 Acquisitions during 1962 to 1983
(t - statistics in parentheses)

Dependent Variable = % Change in Target Equity
measured over the following days:

	<u>t=-1,0</u>	<u>t=-1,1</u>
Independent Variables	-.008	-.053
Constant (1)	(-.142)	(-.885)
ENTERING RELATED MARKETS	-.0081 (-.119)	-.004 (-.050)
CONSOLIDATING MARKET POSITION	.035 (.593)	.025 (.393)
IDENTICAL MARKETS	-.07 (-.932)	-.051 (-.633)
Divested	-.031 (-.837)	-.0397 (-1.001)
Equity Financed	.074 (1.42)	.114 (2.04)
Rival Bidders	.011 (.371)	.023 (.722)
Target P-E Ratio/Bidder P-E Ratio	.005 (1.47)	.006 (1.61)
Post-Williams Act	.0634 (2.44)	.082 (2.93)
Adjusted R ²	.032	.075
Mean of Depen- dent Variable	.101	.107

t = 0 is day of first public announcement of merger

(1) Constant incorporates the effect of % Weighted Unrelated Fits.

Notably, none of the strategic fit variables are statistically significant, which supports Hypothesis Two. The insignificance of the Rival Bidders variable is also consistent with the assumption that the gain received by the target firm is a relatively fixed premium so that any residual value goes to the bidder.

Approximately 27% or 31, of the mergers in the sample had different announcement days for target and bidder. This occurred when a bidder previous to the ultimately victorious bidder showed interest in the target or when rumors involving an unspecified bidder were reported in the Wall Street Journal. In these instances, strategic fit information regarding a different bidder other than the victor may have been impounded into the stock price of the target firm. To control for this effect, the regression model in Table 2 has been rerun with interaction terms for the strategic fit categories and dummy variables noting targets with announcement dates that differed from those of the winning bidders. These results are presented in Table 3.

Separating out targets with mismatched announcement days increased the significance of the position consolidation variable during the announcement period for targets with matched dates. However, the Post-Williams Act variable remains the key determinant of target shareholder gains.

TABLE 3

Estimated Coefficients from Regression of Announcement Period Returns for Targets on Weighted Strategic Fits between Target and Bidder Businesses in 114 Acquisitions during 1962 to 1983
(t - statistics in parentheses)

Dependent Variable = % Change in Target Equity
measured over the following days:

	<u>t=-1,0</u>	<u>t=-1,1</u>
<u>Independent Variables</u>		
Constant (1)	-.01 (-.173)	-.056 (-.892)
MISMATCHED ENTERING RELATED MARKETS	-.125 (-.904)	-.081 (-.551)
MISMATCHED CONSOLIDATING MARKET POSITION	-.068 (-.697)	-.114 (-1.093)
MISMATCHED IDENTICAL (.123)	.0155	.0534 (.395)
MISMATCHED UNRELATED (.843)	.055	.081 (1.16)
ENTERING RELATED MARKETS	.0302 (.393)	.03 (.365)
CONSOLIDATING MARKET POSITION	.092 (1.33)	.098 (1.33)
IDENTICAL MARKETS	-.11 (-1.17)	-.097 (-.967)
Divested	-.026 (-.710)	-.035 (-.881)
Equity Financed	.066 (1.234)	.106 (1.85)
Rival Bidders	-.013 (-.251)	-.021 (-.387)
Target P-E Ratio/Bidder P-E Ratio	.0031 (.916)	.004 (.996)
Post-Williams Act	.072 (2.71)	.09 (3.18)
Adjusted R ²	.03	.06

t = 0 is day of first public announcement of merger

(1) Constant incorporates the effect of Unrelated Fits.

VII. CONCLUSIONS

Both Hypotheses One and Two are supported by the statistical results of the previous section. The return to bidder is a residual which is strongly influenced by the strategic fit between the businesses of the target and of the bidder. Thus, it is incumbent upon management of the bidding firm to carefully analyze potential synergies since they will be the beneficiaries of the resulting gains. Since target firm gains are independent of the business characteristics of the bidder, target shareholders need only accept the highest offer which exceeds their reservation prices.

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